

Valuation in Stressed Times

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Types of Valuation Approaches

1. Conventions of Valuation (Market Based)

- ▶ Historical Valuation
- ▶ Relative Valuation

2. Normative Valuation (Absolute)

- ▶ Discounted Cash Flow
- ▶ Net Assets Valuation

Types of Valuation Approaches

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- Historical Valuation
- Relative Valuation

Price Range –
“Normally”

2. Normative Valuation (Absolute)

- Discounted Cash Flow
- Net Assets Valuation

Intrinsic Value –
“Distressed Times”

⊖ CAUTION!

Valuations based on Market Multiples hold true as long as the market continues to hold the same sentiments.

One Size DOESN'T Fit All

Quality of
Company

Valuation

Tools

Nature of
Business

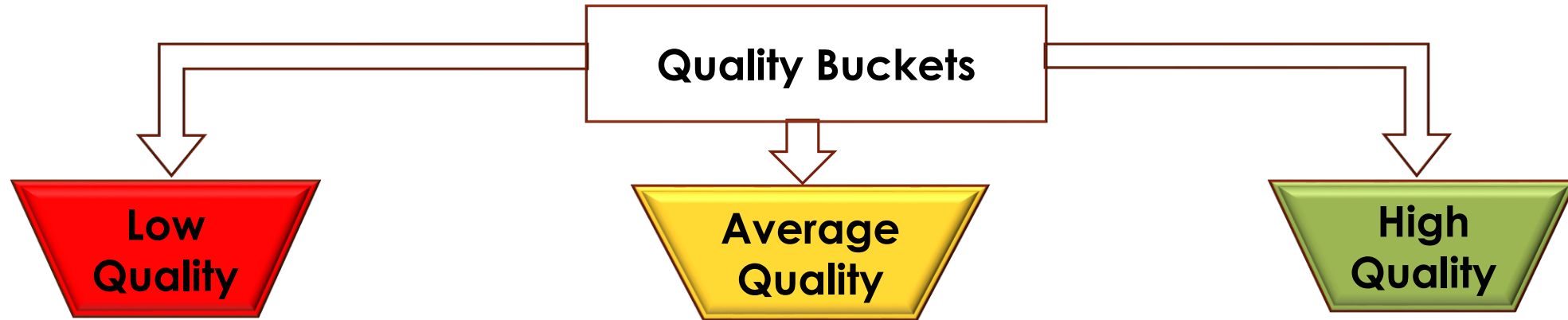
- ✓ Quality of Earnings
- ✓ Cash Flows
- ✓ Balance Sheet

- ✓ Sustainable Competitive Advantage
- ✓ Returns
- ✓ Barriers to Entry

⊖ CAUTION!

Check if the company can survive during economic downturns.

Classification of Companies

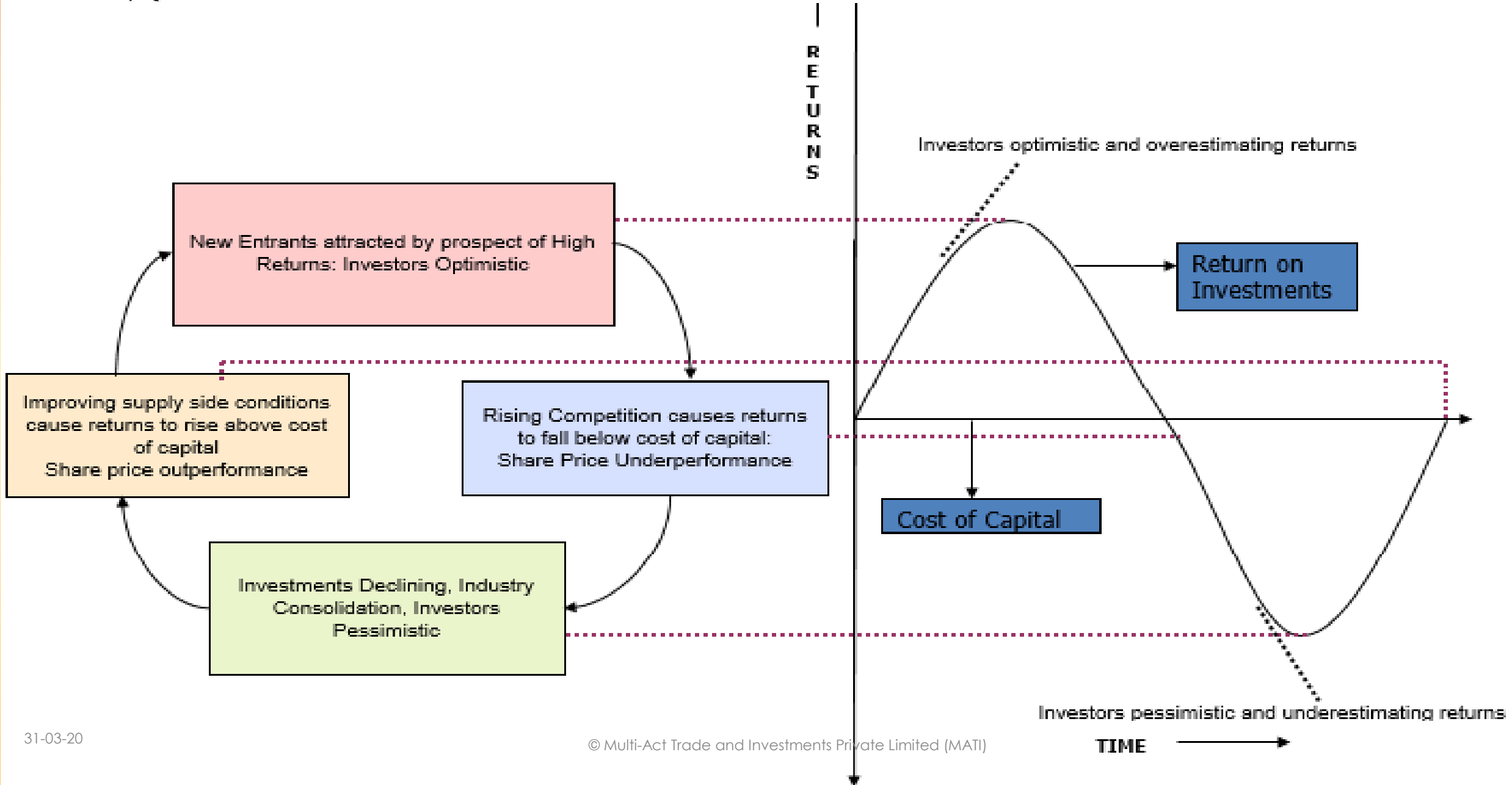


- Accounting Manipulations
- Untrustworthy Management

Poor Quality of Earnings:

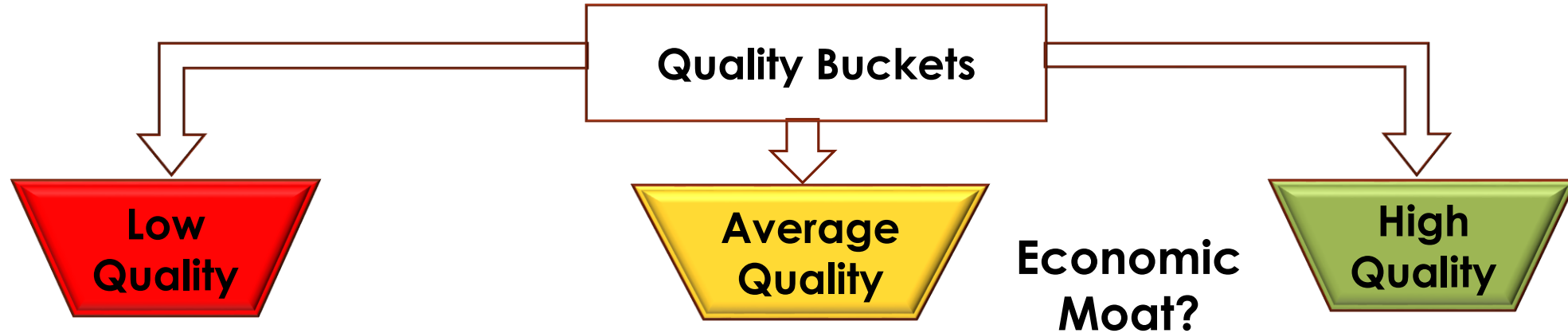
- Lack of FCF
- Poor returns
- Leverage
- Related Party Transactions
- Complex structures

Economic Moat?





Classification of Companies



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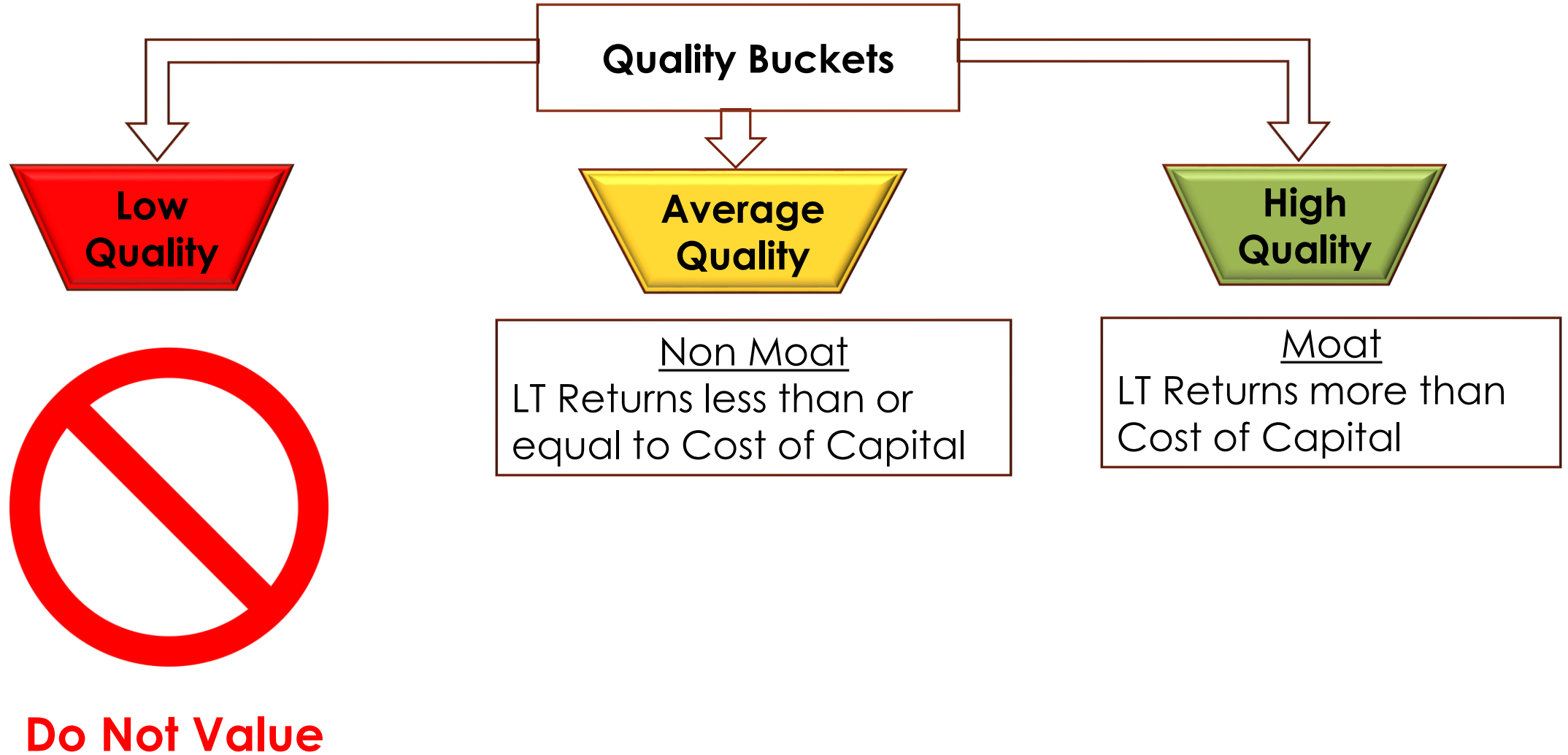
Non Moat

LT Returns less than or equal to Cost of Capital

Moat

LT Returns more than Cost of Capital

Valuation and Quality Buckets



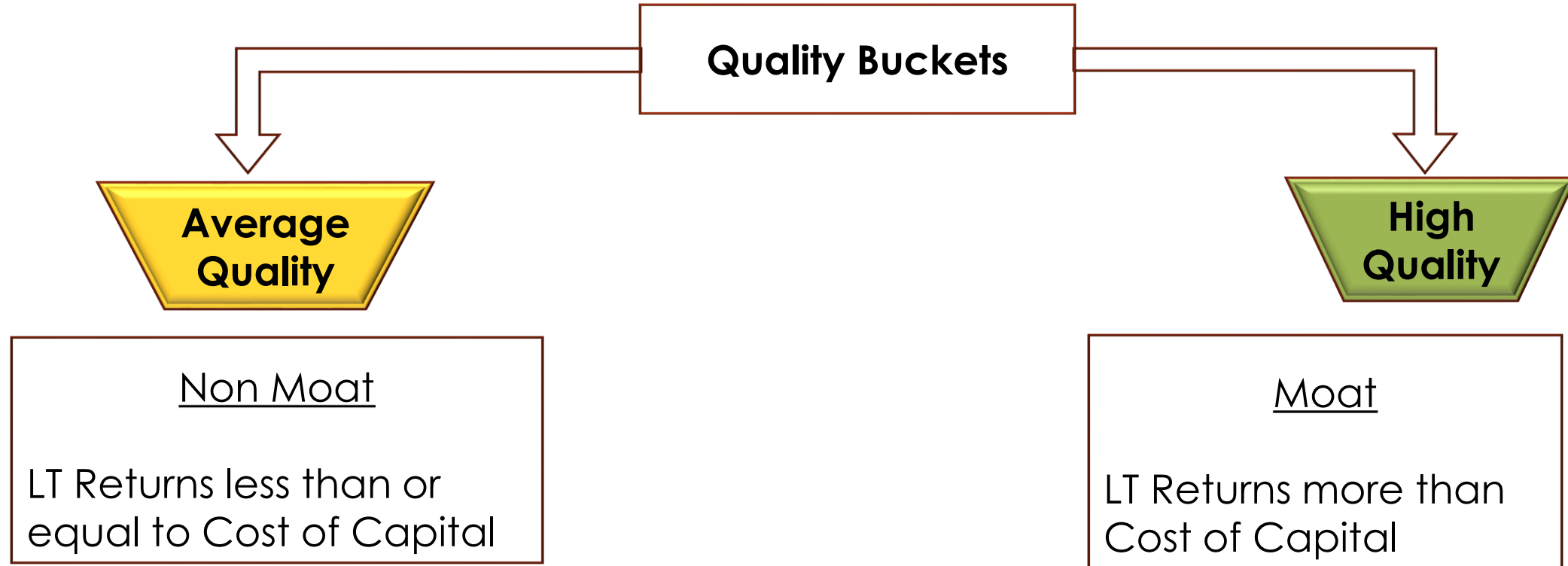


Net Net Value	2013
Cash & equivalents	9,703
Receivables	71,892
Inventories	43,473
other current assets	3,722
Total Current Assets	128,791
Investments	825
Liquid Assets	129,616
Less	
Current Liabilities	93,853
LT Debt	6,214
Other Long Liability	794
Total Liabilities	100,861
Minority interest	640
Net Net	28,114
No of shares	92
Net Net per share	305

⊖ CAUTION!

If the Quality of Earnings is poor, no amount of margin of safety is sufficient enough to protect yourself from permanent loss of capital.

Valuation – Two Bucket Approach



Valuation Approach – Balance Sheet Based

Historical : P/B, P/Net Net
Adjusted PB, RCA, NAV, ABV

Valuation Approach – Income Statement Based

Historical : P/E, P/S, EV/EBIT etc.
No Growth Valuation



Discount Rate/Cost of Capital

- ▶ Constant Cost of Capital over the market cycle
- ▶ Country wise cost of capital

Cost of Capital for India

	%
Risk Free rate – 10 years' avg. yield on 10 year bond	8
Corporate Risk Premium	3
Cost of Debt	11
Equity Risk Premium	3
Cost of Equity (Nominal)	14
Less : Inflation	6
Cost of Equity (Real)	8

Asset Based Normative Valuation

- ❑ Net Net: Current Assets - All ST + LT liabilities
- ❑ Book Value:
 - ❑ Tangible Book Value (TBV) = Net Worth – Intangibles
 - ❑ Adjusted Book Value = TBV – (Gross NPAs – provision for NPAs)

Justified P/B multiple = Normalized RoCE vs Cost of Debt

	Company A	Company B
Avg RoCE	11%	9%
Cost of Debt	11%	11%
Justified PB	1x	0.8x

❑ Replacement Cost of Capital

Steps

- i. Get the existing capacity details of the company
- ii. Get data of latest capital expenditure by companies in the industry
- iii. Estimate replacement cost of company's capacity

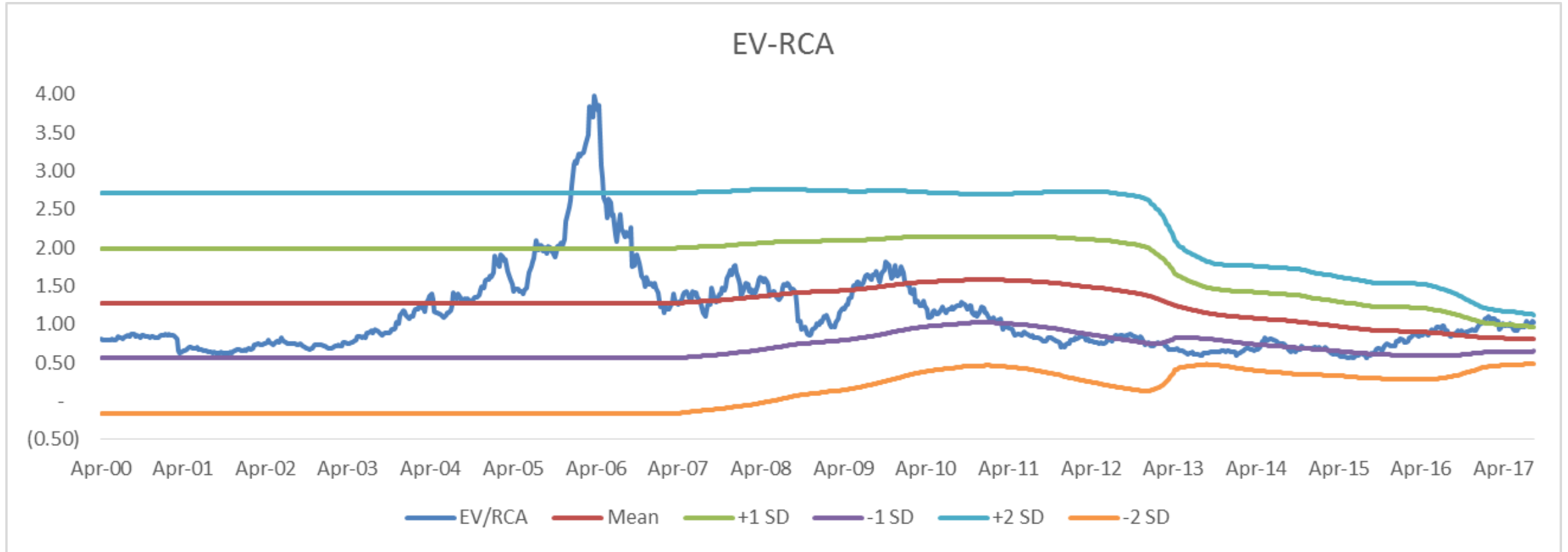
Sugar Company A

- i. Capacity : 76,500 tons per day
- ii. Industry capex data : Rs. 450,000 per ton

RCA – Sugar Company

Particulars	Capacity	Cost /unit (INR mln)	As on 31 Mar 2017			
			Book Value (mln INR)	Value	INR Per Share	
					BV	Value
Sugar (TCD)	76,500	0.45		34,425		
Distillery (KLD)	360	7.87		2,833		
Power (MW)	266			-	>> Included in Sugar RCA	
Capital WIP				61		
Value of Assets			14,214	37,319	60.5	158.8
Investments in associates			510	510	2.2	2.2
Other Assets			62	62	0.3	0.3
Net working Capital (Excl. Cash & ST debt)			19,937	19,937	84.8	84.8
Total Enterprise Value			34,723	57,828	147.8	246.1
Less: Net Debt			19,148	19,148	81.5	81.5
Less: Minority Interest			(3)	(3)	(0.0)	(0.0)
Value attributable to Shareholders			15,578	38,683	66.3	164.6

Market Multiples Based EV/RCA Valuation



EV/RCA		
Range	-1 SD	+1 SD
	Low	High
Multiple	0.65	0.97
EV/RCA - 2018	78	156

Earnings Based Absolute Valuation

❑ Intrinsic Value : PV of future cash flows discounted at the cost of capital.

❑ DCF :

❖ Growth Rate

Company's historical growth subject to

- Change in Corporate Life Cycle
- Industry Growth & Market Share Changes
- Value Migration

❖ Free Cash Flow Generation

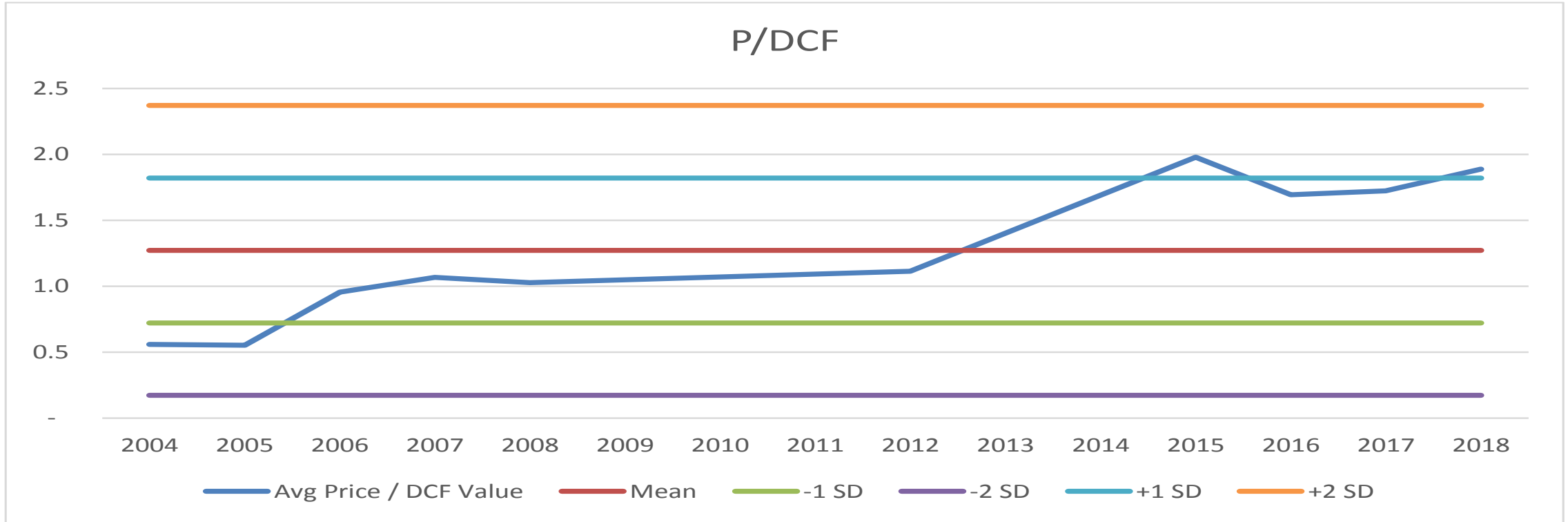
❖ Terminal Value

$1 / (\text{Cost of Equity less Growth})$ subject to quality

Premium for higher returns and growth

		Assuptions
LT Expected Growth Rate -		8
FCF/EPS (%)		60
Discount Rate - Real (%)		8
Terminal Multiple		18
Year	EPS	FCF
2018	18.9	11.4
2019	20.5	12.3
2020	22.1	13.3
2021	23.9	14.3
2022	25.8	15.5
2023	27.8	16.7
2024	30.1	18.0
2025	32.5	19.5
2026	35.1	21.0
2027	37.9	22.7
Terminal Value		682
PV-Cash Flow		114
PV- TermValue		341
DCF Value for March 2018		455

Market Multiples Based P/DCF Valuation



P/DCF Valuation	Low	High
Range	-1 SD	+1 SD
Multiple	0.75	1.90
P/DCF - 2018	342	862

- Stress Test
- ❖ Impact on
 - ❖ Near term earnings
 - ❖ Loss of Revenue
 - ❖ Supply side constraints
 - ❖ Long Term Business
 - ❖ Changes in business practices
 - ❖ impact on competitors
 - ❖ Government Regulations

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What are valuation drivers of the business?

Value of growth

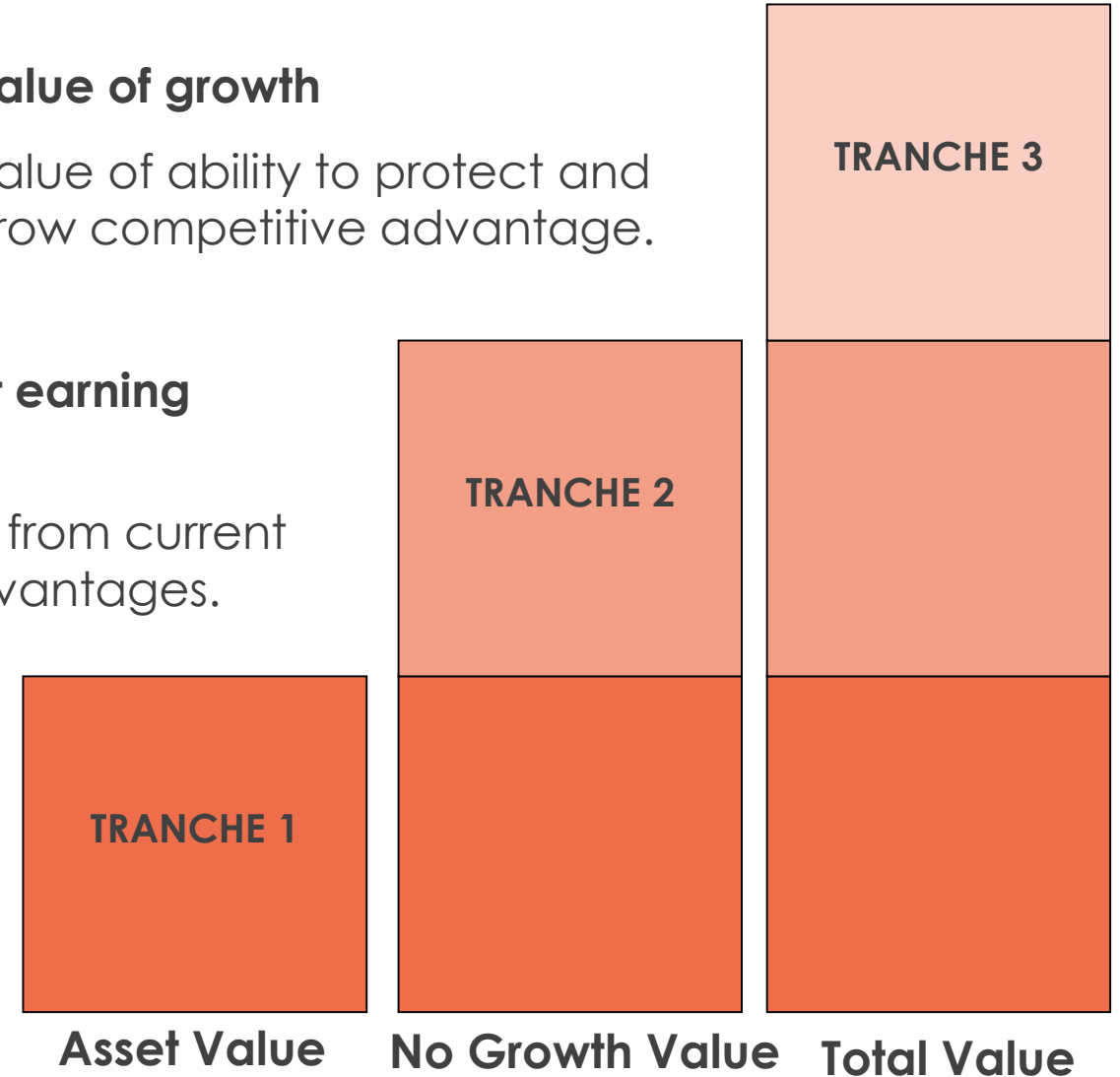
Value of ability to protect and grow competitive advantage.

Value of current earning power.

Franchise value from current competitive advantages.

Value of the tangible assets

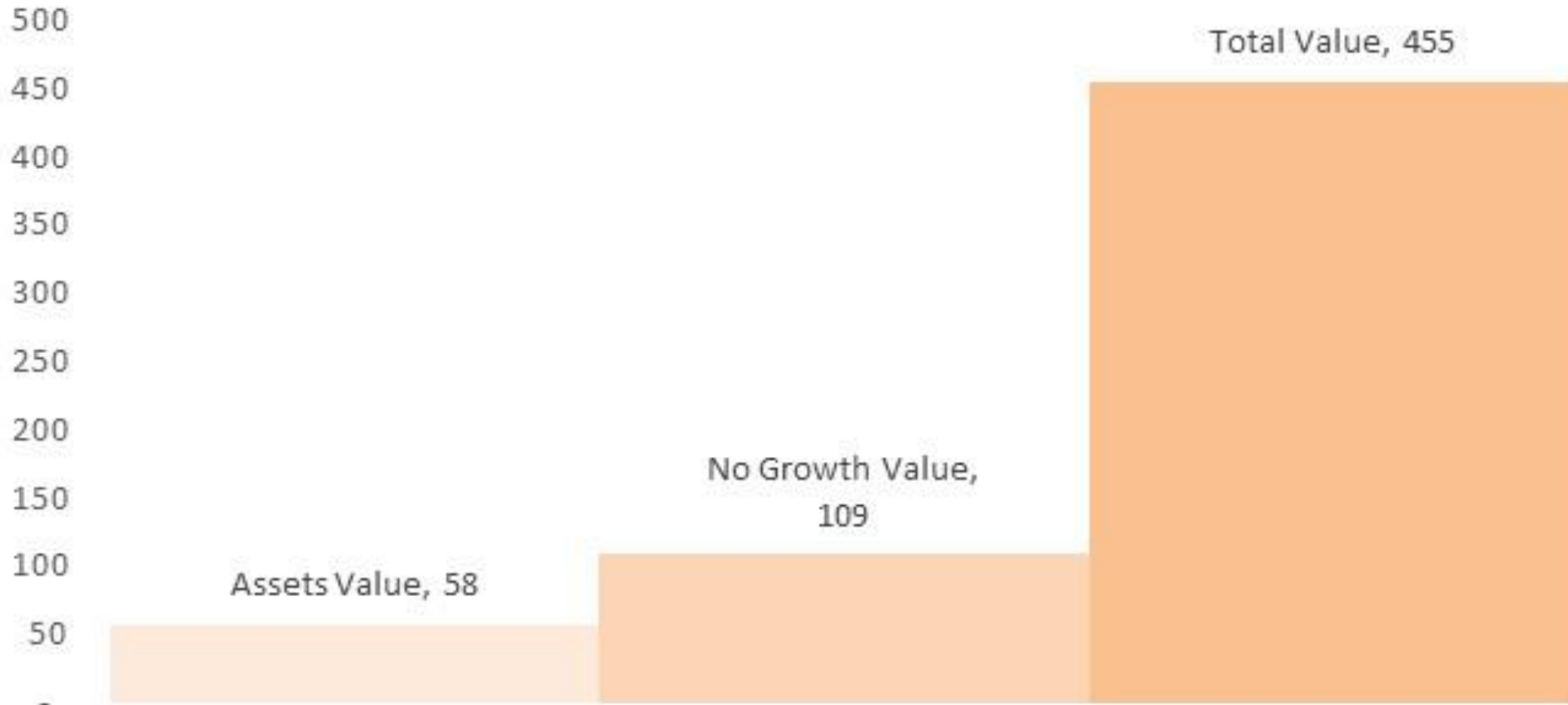
Value of the regular assets of the company.



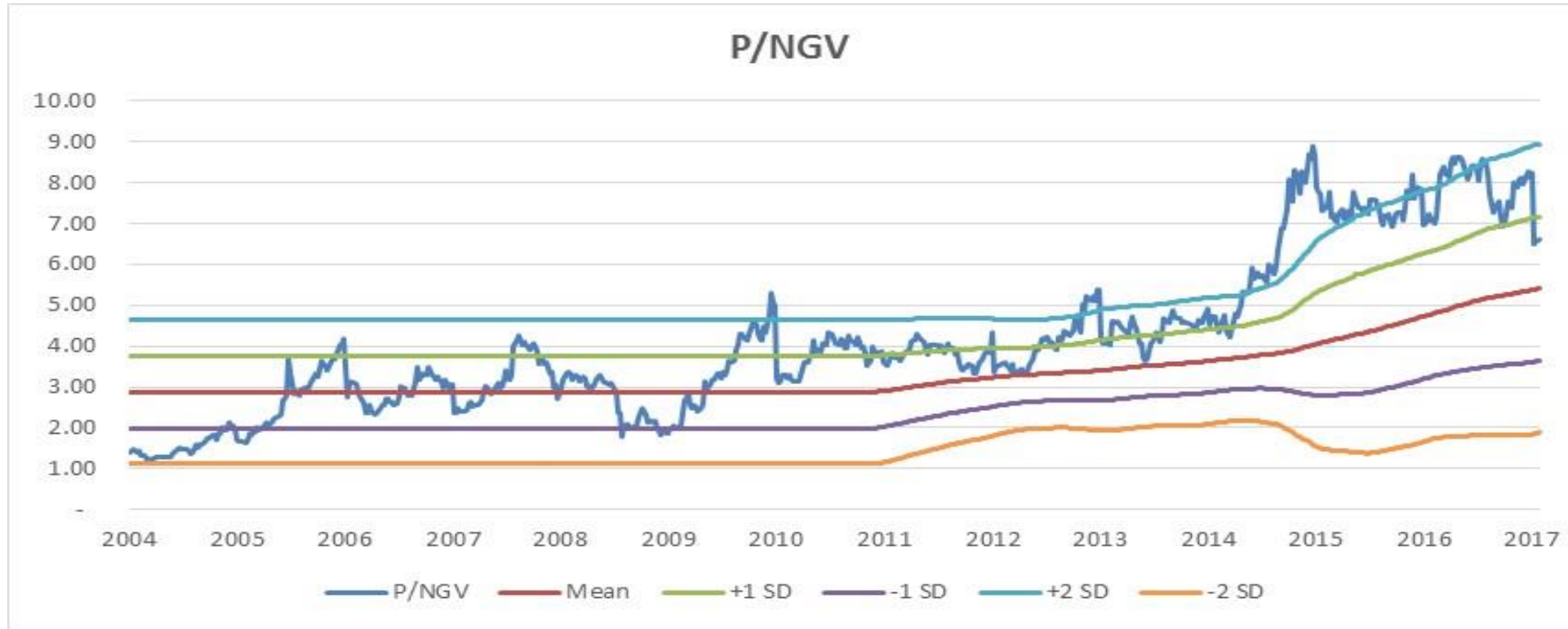
- ▶ Tranche 1 : Value of Assets = BV : Rs. 58
- ▶ Tranche 2 : No Growth Value = Current normalized earnings capitalized for perpetuity

Tranche 2 - No Growth Value	
Revenue for March 2018	60,324
Normalized Operating Profit Margin	14.5%
Normalized Operating Profit	8,747
Tax @ 30%	2,624
Tax break on interest cost	42
Normalized Operating Profit for calculation	6,165
Cost of Capital - Nominal (%)	14%
No Growth Value fo Firm	44,033
Less: Net Debt	(12,768)
Less: Minority Interest	1,273
Investments In Associates	201
No Growth Value - Total for Shareholders	55,327
No Growth Value - Per Share	109

3 Tranche Breakup - per share -2017



Market Multiples Based P/NGV Valuation



P/NGV			
Range		-1 SD	+1 SD
		Low	High
Multiples		3.65	7.17
P/NGV - 2017		535	1,050

3TV and Margin of Safety in Stressed Times

	If the company deserves to quote at	One should buy at	Value drivers
1	Assets Value	Discount to Assets Value	Book Value, Replacement cost of Assets, Net-Net Value, Adjusted Book Value, etc.
2	No Growth Value (Asset Value + Franchise Value)	NGV or discount to NGV	Converting sustainable earnings into perpetual annuity using required return on equity
3	Growth Value (NGV + Present value of incremental income)	NGV or at conservative multiple of NGV	Sustainable growth value

“Price is what you pay. Value is what you get.”
- Warren Buffett